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SUBJECT: EDRC ANNUAL REVIEW OF ITALY, DEC 12

REFS: (A) USOECD 29494

(B) STATE 272354

(C) ROME 17157

(D) OECD DOCUMENT EDR(74)34

1. SUMMARY. ITALIAN DELEGATION GENERALLY SATISFIED WITH SECRETARIAT ANALYSIS OF CURRENT ITALIAN ECONOMIC SITUATION AND PROSPECTS, BUT CONSIDERED CONCLUSIONS TO BE TOO PESSIMISTIC WITH OVERLY ALARMING NUANCES. ITALIANS SEE FLAT GNP GROWTH IN 1975, WITH PRICES RISING 18-19 PER-CENT, SLIGHTLY LESS THAN IN 1974. UNEMPLOYMENT EXPECTED TO REACH 700,000 BY MID-1975 AND HIGHER AT END OF YEAR. BALANCE OF PAYMENTS WILL IMPROVE IN 1975 TO POINT WHERE NON-OIL DEFICIT IS REMOVED. ITALIAN GOVERNMENT POLICIES WILL CONTINUE TO EMPHASIZE DEMAND RESTRAINT IN ORDER TO RESOLVE PRIORITY PROBLEMS OF BALANCE-OF-PAYMENTS DEFICIT

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AND HIGH RATE OF INFLATION. END SUMMARY.

2. GENERAL OUTLOOK: ITALIAN DELEGATION SOMEWHAT CONCERNED THAT PESSIMISTIC JUDGMENTS IN SECRETARIAT DOCUMENT MIGHT HAVE ADVERSE ALARMIST EFFECT ON DOMESTIC AND INTERNATIONAL OPINION. THEY THOUGHT INSUFFICIENT ATTENTION HAD BEEN GIVEN TO EXTENT RESTRICTIVE POLICIES HAVE ALREADY BEEN ADOPTED BY GOI AND THEIR IMPACT ON ITALY'S DIFFICULT PROBLEMS. ITALIANS DO NOT FEEL THAT SOCIAL COSTS OF NECESSARY RESTRICTIVE MEASURES WILL CREATE UNMANAGEABLE TENSIONS.

3. GOVERNMENT'S GENERAL ECONOMIC APPROACH: CHIEF ITALIAN DELEGATE (CAFAGNA) DESCRIBED GOI POLICY AS AIMING FOR IMPROVEMENT BALANCE-OF-PAYMENTS POSITION AND CONTAINMENT OF ECONOMIC SLOWDOWN. TO EXTENT THESE OBJECTIVES CONTRADICTORY, GOI SEEKING TO ACT ON BALANCE OF PAYMENTS WHILE MINIMIZING ANY ADVERSE EFFECTS ON DOMESTIC ECONOMY. CONTAINMENT OF INFLATION NECESSARY TO ACHIEVE BOTH OBJECTIVES. TIGHT MONETARY STANCE AND POLICY OF NARROWING BUDGET DEFICIT WILL BE PURSUED, WHILE GOVERNMENT SEEKS TO INFLUENCE SOCIAL CONFLICTS BY MAKING CLEAR TO LABOR THAT ATTEMPTS TO ACHIEVE FURTHER REAL WAGE INCREASES WILL BE OFFSET THROUGH TAX MEASURES. HOPE IS THAT TEMPORARY SLOWDOWN IN ECONOMY NEED NOT BE MAINTAINED BEYOND END 1975. GOVERNMENT IS WORKING ON NEW PROGRAM OF MEASURED EXPANSION DESIGNED AS WELL TO IMPROVE ECONOMIC STRUCTURE IN MEDIUM-TERMS IN ENERGY, FOOD AND HOUSING SECTORS. PROGRAM WILL BE HELD IN READINESS AND IMPLEMENTED WHEN THERE HAS BEEN SUBSTANTIAL REDUCTION IN INFLATION, SIGNIFICANT IMPROVEMENT IN BALANCE OF PAYMENTS AND "ADEQUATE RESTORATION" OF WORLD DEMAND.

4. OUTLOOK FOR DEMAND AND OUTPUT: ITALIAN DELEGATION EXPECTS REAL GNP TO BE FLAT THROUGHOUT 1975 UNLESS THERE IS RECOVERY OF ECONOMIC ACTIVITY IN MAIN TRADING PARTNERS. THEY FORESEE TWO PERCENT DECREASE IN DOMESTIC DEMAND, WITH CONSUMER DEMAND FLAT AND INVESTMENT DEMAND DROPPING BY 7 PERCENT. EXTERNAL DEMAND IS SEEN RISING BY 6 PERCENT, BUT MAINLY DUE TO SERVICE ACCOUNT.

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ITALIANS ARE NOT VERY CONCERNED ABOUT FALL IN INVESTMENT IN 1975, SINCE BELIEVE INVESTMENT BOOM IN 1973-74 HAS CREATED ADEQUATE LEVEL OF CAPACITY FOR CURRENT LEVEL OF DEMAND.

5. U.S. ASKED ABOUT DOMESTIC IMPLICATIONS OF IMPORT DEPOSIT SCHEME WHICH HAS GIVEN ONE-TIME SUPPORT TO MONETARY MANAGEMENT IN 1974. ITALIANS RESPONDED THAT

THERE WILL BE GRADUAL PHASE-OUT IN EARLY 1975 WHICH WILL ADMITTEDLY ADD TO MONETARY BASE. EEC OBSERVER STATED THIS STIMULUS TO ECONOMY MIGHT IMPROVE GROWTH PROSPECTS FOR LATE 1975.

6. EMPLOYMENT OUTLOOK: ITALIANS SEE LEVEL OF UNEMPLOYMENT RISING TO 700,000 BY MID-1975, WITH FURTHER RISE BY END OF YEAR. SECRETARIAT AND EXAMINING COUNTRIES THOUGHT THIS FIGURE MODEST IN VIEW OF FLAT GNP PRO-

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JECTION, TO WHICH ITALIAN REPLIED THAT THEY EXPECT UP TO TWO-YEAR LAG AFTER LOWPOINT IN ECONOMIC ACTIVITY BEFORE UNEMPLOYMENT REACHES PEAK, ASSUMING 1964-66 PATTERN REPEATS ITSELF.

7. PRICE OUTLOOK: ITALIANS EXPECT RATE OF INCREASE OF CONSUMER PRICES TO FALL SLIGHTLY IN 1975 TO ABOUT 18-19

PERCENT ANNUAL RATE. EDRC WAS SKEPTICAL ABOUT SECRETARIAT FORECAST OF RAPID REDUCTION FROM 21.75 PERCENT RATE IN 1975-I TO 12.5 PERCENT IN 1975-II. ITALIANS SAW MORE MODEST FIRST-HALF FIGURE BASED ON INDICATIONS THAT WHOLESALE PRICE INDEX IS NOW RISING MORE SLOWLY THAN CPI. WHEN ASKED IF SOFTNESS OF LABOR MARKET WOULD REDUCE PRESSURE FOR INFLATIONARY WAGE DEMANDS, ITALIANS WERE UNWILLING TO SPECULATE. THEY ALSO THOUGHT THAT SCOPE FOR PRICE AND INCOME RESTRAINT IN ANY FORMAL WAY WAS LIMITED, BUT THEY WERE HOPING TO CREATE A TYPE OF SOCIAL COMPACT INVOLVING TRADE-OFF BETWEEN WAGE RESTRAINT BY LIMITED OFFICIAL USE

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UNIONS IN RETURN FOR PROGRESS ON SOCIAL BENEFITS (I.E., IMPLEMENTATION OF "REFORMS") BY GOVERNMENT.

8. BUDGET OUTLOOK: ITALIANS NOTED DIFFICULTIES OF MAINTAINING EFFECTIVE BUDGETARY CONTROL WHEN MORE THAN HALF OF EXPENDITURES RESULT FROM TRANSFER PAYMENTS TO LOCAL GOVERNMENTS. THEY ANTICIPATE CASH BUDGET DEFICITS OF 8,500 BILLION LIRE IN 1974 AND 8,400 BILLION LIRE IN 1975. IN 1974, ALMOST ALL DEFICIT FINANCING INVOLVED EXPANSION OF MONETARY BASE, IN VIEW OF WEAKNESS OF BOND MARKETS, BUT IN 1975 ITALIANS EXPECT AT LEAST ONE-THIRD OF BUDGET DEFICIT TO BE FINANCED ON BOND MARKETS. THERE WAS CONSIDERABLE DOUBT IN EDRC AS TO ABILITY ITALIANS TO MEET TARGET FOR DEFICIT AND ITS FINANCING.

9. BALANCE OF PAYMENTS: ITALIANS EXPECT CONSIDERABLE IMPROVEMENT IN CURRENT ACCOUNT DEFICIT IN 1975, WITH DEFICIT REDUCED TO 2,500 BILLION LIRE. THIS MEANS THAT NON-OIL DEFICIT WILL BE WIPE OUT NEXT YEAR. TO ACHIEVE THIS RESULT, ITALIANS SEE REDUCTION IN IMPORT VOLUME OF 1 PERCENT AND INCREASE IN EXPORTS OF GOODS AND SERVICES BY 6 PERCENT. AT SAME TIME, IMPORTS WILL RISE IN VALUE TERMS BY 16.5 PERCENT AND EXPORTS BY 30.5 PERCENT. ITALIANS DO NOT ANTICIPATE GAINS IN MARKET SHARES. MAIN INCREASES WILL BE IN EXPORTS OF GOODS TO NON-OECD COUNTRIES (INCLUDING OIL EXPORTERS) AND HIGHER LEVEL OF TOURIST RECEIPTS DUE TO FORTHCOMING HOLY YEAR. ITALIANS DO NOT THINK EXPORTS HAVE YET BENEFITTED FULLY FROM PAST DEVALUATIONS. THEY ASSUME NO FURTHER CHANGES IN EXCHANGE RATE PARITY IN 1975.

10. ITALIANS STATED FINANCING OF 1975 DEFICIT WILL COME FROM THREE SOURCES: (A) INTERNATIONAL INSTITUTIONS (FINAL TRANCHE OF IMF STANDBY, DRAWINGS ON IMF OIL FACILITY, BORROWING FROM EC AND POSSIBLE NEW OECD FACILITY,) (B) DRAWING ON BILATERAL SWAPS, INCLUDING

POSSIBLE NEW SWAPS AND (C) DRAWDOWN OF RESERVES. TOTAL

DEBTS ALREADY OUTSTANDING AMOUNT TO 13 BILLION. PRINCIPAL REPAYMENTS WILL FALL DUE AS FOLLOWS (IN APPROXIMATE
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ROUNDED AMOUNTS): \$1.0 BILLION IN 1975, 2.0 BILLION IN 1976, 1.0 BILLION IN 1977, 2.5 - 3.0 BILLION IN 1978, 1.0 BILLION EACH YEAR THEREAFTER TO 1973. IN ADDITION, INTEREST OF ABOUT 1.0 BILLION WILL FALL DUE IN EACH YEAR UP TO 1978, DECLINING THEREAFTER.

11. WITH REGARD TO RECENTLY ANNOUNCED PLAN TO CONSERVE ENERGY (REF C, PARA 7, ITALIANS WERE UNABLE TO SAY WHAT MEASURES WERE BEING CONSIDERED, BUT SUGGESTED NATURAL DECREASE IN OIL CONSUMPTION DUE TO PRICE EFFECTS AND ECONOMIC SLOWDOWN HAD ALREADY LED TO 5 PERCENT REDUCTION IN 1974 FROM 1973. EXTENT TO WHICH ANY NEW ACTION NEEDED TO CONSERVE ANOTHER 5 PERCENT WOULD DEPEND UPON HOW CONSUMERS CONTINUE TO REACT TO INFLUENCES ALREADY ACTING UPON THEM.

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